CP&L

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William Cavanaugh III
President
and Chief Executive Officer

May 7, 1997

The Honorable John D. Dingell, Ranking Member
Commerce Committee Democratic Office
564 Ford House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Dingell:

Carolina Power & Light Company (CP&L) appreciates the opportunity to respond to your questionnaire regarding electric industry restructuring. CP&L supports your statement that it is important to have as full an understanding of the facts as possible before any changes are made to existing electric utility laws and before considering the enactment of new legislation. We believe it is paramount that decisionmakers not make hasty decisions that could jeopardize a service that is vital and unlike any other service provided anywhere in the world.

The facts show that the current system of electric utility regulation has resulted in the United States having electricity prices among the world's lowest – rates far below other industrial countries. The United States' industrial firms pay about one-fourth what their Japanese counterparts pay and half, or less, of what German, Swiss, or Italian firms pay. Further, while most countries have experienced increasing electricity prices, prices in the United States have declined over 25% since 1982 (adjusted for inflation). This price decline results from generation efficiencies, decreasing fuel costs, newer and more cost-efficient plants, an increasing number of power plants being fully depreciated, and prudent regulation.

CP&L supports change that benefits all customers, provides for continued service reliability, and is fair to utility shareholders. This sounds straightforward, but is extremely complex. We ask you and your colleagues to proceed with caution and due deliberation before making any changes to the existing electric utility regulatory system.

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1. **From your company's point of view, is it necessary for Congress to enact legislation bearing on retail competition, and why? If you favor legislation, please outline which issues should be addressed and how you think they should be resolved.**

CP&L believes it is not necessary for Congress to enact legislation bearing on retail competition. We firmly believe states and state commissions should determine retail electric policies, which includes electric industry restructuring policies. We agree with NARUC's Principles that:

> *Restructuring should recognize the unique characteristics of the various States. State legislatures and state public utility commissions are most accountable to the people and are closest to the people, problems, and opportunities that restructuring will present at the retail level. Accordingly, the policy and implementation decisions related to retail electric service should be determined by the States.*

The states in which we serve (North and South Carolina) have historically benefited from sound electric utility regulation and legislation, as evidenced by our electric rates being below the national average and as further evidenced by our solid, strong economic growth.

Each state is unique in its position and use of electricity and its approach to utility regulation. Climate, demographics, population, investment in demand-side management and conservation, reliance upon nuclear generation, concern for the environment, customer mix, and transmission system capabilities all impact the cost of electricity and vary by region and state. As a result, it would be inefficient and inappropriate to pursue a "one-size-fits-all" restructuring of the electric utility industry. The right of each state to deliberately and thoughtfully determine what is in the best interest of its citizens must not be undermined nor adversely affected by Congressional legislation.

The level of activity already underway regarding electric utility regulation confirms that the states do not need prodding from the federal government. To date, 49 states are addressing this issue in a manner and in a time-frame deemed appropriate for that state's needs. (Tennessee is the only state that does not have activities underway of which we are aware.) Each state, and appropriately so, is at a different juncture in the restructuring process. For Congress to say "how" and "when" these decisions are to be made would usurp the states' authority and unnecessarily complicate the process.

States must be given the flexibility (policy, time-frame, mechanisms, etc.) to properly address the many important and complex issues involved in the electric utility industry. The states are in the best position to meet the needs of their consumers and appropriately address the unique characteristics of their own energy markets.

2. If the state(s) you serve has adopted or is considering adopting retail competition, what are your biggest concerns? Please be specific. Indicate how you are dealing with them and any recommendations you may have.

CP&L supports competition that benefits all customers; preserves the safety, reliability, affordability, and efficiency of the electric system; and is fair to utility stockholders. Any retail competition proposal which does not satisfy this criteria is of concern to us.

The North Carolina legislature has established a Study Commission on the Future of Electric Service in North Carolina. That Commission is charged to "...examine the cost, adequacy, availability, and pricing of electric rates and service in North Carolina to determine whether legislation is necessary to assure an adequate and reliable source of electricity and economical, fair, and equitable rates for all consumers of electricity in North Carolina..... [T]he Commission shall fully address the following issues:

1. Assurance of fairness and equity among all customer classes;
2. Reliability of power supply;
3. Fair treatment of competing power providers;
4. Universal access to electric energy and assignment of responsibility to provide it;
5. Reciprocity between states;
6. Stranded investment costs and benefits;
7. Clarification of state and federal jurisdiction;
8. Environmental impact of restructuring;
9. Impact of competition on tax revenue;
10. Alternative forms of regulation;
11. Obligation to serve and the obligation to receive service;
12. Ways to eliminate or equalize subsidies and tax preferences;
13. Customer choice of electric providers;
14. Functional unbundling of electric power generation, transmission and distribution services;
15. Impact of competition on service to low-income consumers;
16. Impact of competition on renewable energy, conservation, and efficiency programs;
17. Impact of competition on the energy expenditures by state and local government;
18. Impact of competition on economic development;
19. Impact of competition on municipal electric utilities and rural electric cooperatives;
20. Prevention of anticompetitive or discriminatory conduct or the unlawful exercise of market power; and
21. Other relevant and appropriate subjects."

CP&L will have representation on the Study Commission and plans to be an active participant. Of the issues listed above, the most important include fairness among all customers, reliability, affordability, clarification of federal/state jurisdiction, fair treatment of competing power providers, stranded cost recovery, and unbundling of utility services.

The issue of fairness is not limited to leveling the playing field among power providers (please see our response to Question#6), but includes fairness among consumers to ensure that no one is harmed by the changes being proposed for the electric utility industry. Fairness goes hand-in-hand with our belief that any changes to the existing utility structure be beneficial to all consumers and provide all consumers safe, reliable, efficient, and affordable energy services.

The importance of a reliable and affordable electric system cannot be overemphasized. As further discussed in our response to Question #8, the United States has one of the worlds most reliable interconnected electric systems with service, on average, at lower prices than any other industrialized nation. Consumers now rely on very high service quality and their well-being and the economic growth of our country require that it be maintained. Additionally, through state commission oversight, rates are established in a manner that is fair to all and are intended to make electricity available and affordable to the widest number of customers possible. Such protections must be preserved.

Regarding federal/state jurisdiction, the FERC has adopted in its Order No. 888, a methodology for determining the demarcation between state and federal jurisdiction over electric systems. Provided the FERC defers to the states in applying its methodology for arriving at the demarcation, the overall procedure appears reasonable.

Regarding fair treatment of power providers, as explained in our answer to Question #6, it is essential that no electric supplier be afforded a competitive advantage because of state or federal governmental assistance. This means all suppliers must be subject to the same tax treatment and be eligible for the same governmental loans and subsidies. In a deregulated world, neither state nor federal government should favor one supplier over another.

With regard to unbundling, as explained in more detail in our response to Question #4, distribution services should not be unbundled. In order to preserve the integrity and reliability of the system and to protect consumers, the distribution company should be regulated and provide all distribution services, including metering.

Finally, turning to stranded cost recovery, in our answer to Question #3(b) we explain why past regulatory commitments must be honored and utilities given an opportunity to recover all just, reasonable and prudent costs incurred in furtherance of their obligation to serve.

Four bills were introduced in the South Carolina General Assembly this session related to restructuring of the electric utility industry. Appropriate subcommittees are conducting hearings on the complex issues so important to these deliberations.

3. **Whether or not you favor federal legislation, please indicate your position on the following specific issues (to the extent not addressed in your prior response):**

   a. ***A Federal mandate requiring states to adopt retail competition by a date certain.*** **If retail competition is under consideration in the state(s) you serve, do you believe Congress should provide additional direction or authority?**

As explained in our response to Question #1, we believe that there should not be a federal mandate requiring the states to implement retail competition by a date certain. Rather, each state should be allowed to implement competition at the time and in the manner that is most appropriate to each states' unique situation.

   b. ***Recovery of stranded investment.*** **If the state(s) you serve already has adopted retail competition, how was this issue addressed and are you satisfied with the outcome? If your state(s) is considering adopting retail competition, how would you recommend that this issue be treated? Do you think Congress should enact legislation relating to stranded cost issues, and if so what would you recommend? Is securitization a useful mechanism for dealing with stranded costs, and whom does it benefit?**

For over 30 years, CP&L has been required by law to plan, build, and maintain adequate resources to meet the electricity needs of every single customer that chooses to locate in our assigned service territories in the two Carolinas. The vast majority of costs CP&L incurred to meet this obligation have been reviewed by the state commissions and found to be just, reasonable, and prudently incurred. These costs reflect expenses associated with demand-side management programs, purchased power contracts with qualifying facilities pursuant to the Public Utility Regulatory Policy Act of 1978, diversified generation resources to insure reliable electricity at stable rates and 20% reserve margins. Many of these costs would not have been incurred in a deregulated environment and will not be recoverable at market-based prices following deregulation. Ignoring these costs or shifting them to other customers or stockholders would be wrong, inequitable, and unconstitutional.

This was the conclusion reached by the FERC in its recent Order No. 888:

> *Indeed, we are particularly concerned that the failure to assign stranded cost responsibilities to customers that have access to alternative suppliers will leave captive customers exposed to the risk of greater cost burdens, thereby shifting to captive customers the costs that were originally incurred for the benefit of the (typically larger) customers who have the flexibility to take early advantage of competing power suppliers.*
> (page 514)

The treatment of stranded costs is a critical component of any restructuring activity and, consistent with our response to Question #1, electric industry restructuring policies are the responsibility of the states and state commissions, which are much-better equipped to deal with the issue.

The importance of stranded cost recovery to the financial community and, in turn, to stockholders and investors cannot be over-emphasized. Investors have never been compensated for the risk of possibly not recovering these costs under ratebase rate of return regulation or for the risk associated with restructuring the industry to allow retail competition.

Regarding securitization, that concept might be a useful mechanism for stranded cost collection because (1) it may provide the opportunity to reduce financing costs by substituting securitized debt for average cost of utility capital and (2) it may provide the opportunity to reduce revenue requirement by extending the period over which costs are collected. Consequently, its usefulness depends on the equity and debt costs used to finance the stranded assets and the remaining book life of the stranded assets. Since stranded costs are assumed to be collected, securitization makes the annual payments lower (just like mortgages or installment payments spread out the costs of houses and cars). Securitization may also be a good option for balance sheet items like uneconomic plant and regulatory assets. Off balance sheet items (like purchased power contracts) might have to be treated differently.

However, there are serious questions regarding the tax treatment of proceeds from securitization financing. For securitization to be a viable stranded cost recovery mechanism, tax laws need to clearly provide that there is no taxable gain on the receipt of proceeds from securitization financing; otherwise, the tax cost would eliminate any potential savings from the use of securitization. Further, securitization needs:

- to have the full backing of legislators and regulators,
- an irrevocable right to recovery - a pledge on future legislators,
- a true-up provision in case the stranded estimate is incorrect, and
- legislation - not just a regulatory order - to have the full faith of the state behind it.

Without the above factors, securitization may not be desirable.

c. *Reciprocity.* Can states condition access to their retail markets on the adoption of retail competition by other states? Should Congress enact such a requirement? Could such a requirement create an incentive for states with low electric rates not to adopt retail competition, in order to keep cheap power at home?

The issue of reciprocity must be addressed within the larger context of the states' constitutional right to enact laws, regulations and provisions to protect the safety and welfare of its citizens. Just this year, the United States Supreme Court in a case involving the taxation of natural gas marketers in Ohio reaffirmed the states' rights in this area. As acknowledged by federal legislation that has been introduced to deregulate the electric industry, in order to protect the safety and welfare of their citizens the states must be allowed to:

- create universal service funds in order to ensure that all customers continue to have access to reliable and affordable electricity;
- levy charges to support the continuation of programs designed to encourage the generation of electricity in environmentally benign ways and assist customers in utilizing electricity efficiently; and

- be allowed to place restrictions upon electric suppliers, such as requiring the registration of all suppliers.

Thus, to the extent a state determines that some type of reciprocity requirement is necessary to protect its citizens, they should be allowed to enact such a requirement.

The issue of reciprocity emphasizes the need for states to be allowed to assess non-bypassable stranded cost charges. If reciprocity is not required, any perceived resulting inequities can be greatly mitigated if all of the customers located in a state that allows competition are required to pay a non-bypassable stranded cost fee that compensates the state's utilities for their stranded cost. Under this scenario, all electric suppliers will be competing for customers based upon their marginal costs and the issue of stranded cost recovery (which has been caused by that state allowing competition) will not be a factor.

It is interesting to note the reference in your question to states with low-cost power electing not to allow competition if reciprocity is required in order to prevent their low-cost electric suppliers from selling their power outside the state. (In other words, the states refuse to allow competition so they can maintain their state's "monopoly" on low-cost power.) The deregulation debate has been framed from the perspective of the high-cost states and their need to lower rates. Your question brings into focus the fact that those states with low electric rates are being asked to relinquish their current right to absolute entitlement to their utilities' low-cost power. As shown on Attachment I to this response, it is important to remember that recent statistics show 32 states have electric rates below the national average. This puts these states and their citizens in a materially different position than the high-cost states. They do not have nearly as much to gain and possibly have much to lose from deregulation. This is further evidence that a "one-size fits all" approach is not in the public interest.

4. If Congress enacts comprehensive restructuring legislation, should it mandate "unbundling" of local distribution company services? What effects would this have, and would they differ for various customer classes? Would this entail substantial expense, and who would incur any such costs?

The concept of "unbundling" of distribution services is an ill-defined term and the extent to which unbundling should be required is the subject of great debate. As explained below, for safety, reliability, and consumer protection reasons, distribution services (including metering) should not be unbundled, regardless of how the term is defined. Again, this decision is best left to the states, based upon their consideration of specific circumstances.

The distribution company will be asked to regulate and schedule the delivery of electricity to hundreds of thousands or even millions of end-use customers who are obtaining electricity from myriad suppliers. In order to do so, it must have absolute control over the delivery system. Given that electricity cannot be stored in any meaningful quantities, a customer's supplier must produce the exact amount and type of electricity that the customer consumes on a real-time basis every second of every day. If this does not occur, either a third party (in all probability, the distribution company) must step in and provide the necessary electricity or the customer will suffer voltage problems or power outages. If the distribution company is not in control of the entire distribution system (including the meters), then a supplier can shift its load-following responsibilities to a third party because the distribution company will not be in a position to know whether the supplier is actually matching production with consumption (nor will the distribution company know the amount and extent to which it or another party is being required to provide regulation services). Basically, the distribution company cannot afford to have an entity with a direct financial interest in "gaming" the system controlling a portion of the system.

From a reliability perspective, in order for the distribution company to schedule, control and deliver electricity to millions of customers reliably, it must have real-time knowledge of the electricity flows occurring on its system. If portions of the system are controlled by third parties, this will not be the case.

Turning to consumer protection, it is imperative that the distribution companies own and control the provision of metering services. First of all, the provision of electricity is potentially extremely dangerous. Unless the appropriate steps are taken and standards complied with, the risk of property damage, personal injury and even death is a serious possibility. Thus, it is imperative that meters and lines be properly installed, meet certain threshold standards, and be properly maintained. In addition, from a customer service/billing protection perspective, there is no more important piece of equipment than the customer's meter. In which of the following cases is the customer better protected:

1) allowing an unregulated generation provider whose revenues depend upon the amount of electricity consumed and billed to own the meter; or,

2) allowing a regulated distribution company whose rates are not subject to the amount of product consumed by the customer to own the meter?

The answer is obvious. The distribution company will treat all customers and electric suppliers fairly, equitably, and in a nondiscriminatory manner. Given that the distribution company will be regulated and will not be competing with any electric supplier, electric suppliers will not have

to worry about the distribution company showing a preference for or giving a competitive advantage to another supplier.

There is also an administrative and practical reason why the distribution company must retain control and ownership of metering services. If each marketer, aggregator, broker, and electric supplier installs its own meter, the logistical difficulties of a customer switching electric suppliers will be greatly increased. The customer will have to schedule the removal of the previous supplier's meter as well as the installation of the new supplier's meter in such a manner that the customer does not experience a service outage. The coordination of these two activities will be a severe challenge. Furthermore, the distribution company that is totally dependent upon these third parties for metering data will experience similar difficulties coordinating the collection of the necessary data as suppliers come and go.

Unbundling of distribution services would create a complex and confusing maze of service providers and decisions for consumers and the opportunity for consumer fraud. Unbundling of distribution services would create the necessity for substantial additional regulatory resources to educate consumers and to provide consumer protection services. Some states have estimated the initial cost of this to require additional funds of $20 - $37 million. Unbundling of distribution services is not necessary to promote competition for electric generation. There is no need to further confuse and complicate any industry restructuring by requiring the unbundling of distribution services.

Finally, with regard to the expense associated with "unbundling," the answer is intuitively obvious: the expense will be much greater with unbundling than would be the case if the distribution company continues to provide all distribution delivery services. All of the necessary resources, facilities and expertise are possessed by the incumbent electric utility. The meters are in place, the facilities installed, and the personnel trained and ready to perform. The unbundling of distribution services will carry a cost that must ultimately be borne by the customer. As explained above, since such duplication will provide no value to the customer, there is no economic, technical, or practical reason to incur these costs.

5. Recently Chair Moler of the Federal Energy Regulatory Commission recommended that, as part of comprehensive legislation, Congress authorize the Commission to enforce compliance with North American Electric Reliability Council standards to help maintain reliability of service. Do you believe this is necessary, and why or why not?

NERC is currently reviewing this issue and we believe it is premature for Congress to consider legislation on this issue until NERC completes its investigation and recommendation. Further, we expect that the industry can develop the mechanism necessary to regulate itself. Eventually, some regulatory backstop may be needed, but that is not necessary at this time.

6. What concerns does your company have with respect to the role of public power and federal power marketing agencies in an increasingly competitive wholesale electric market? In markets in which retail competition has been adopted? Are there concerns you would like to have addressed if Congress enacts comprehensive restructuring legislation? Should Congress consider changes to federal law as it applies to regulation of public or federal power's transmission obligations?

A fundamental principle in a deregulated industry is that neither the state nor the federal government should afford any competitor an unfair advantage. Currently, municipal electric systems enjoy the benefit of tax-exempt financing. Public power agencies, such as the Tennessee Valley Authority, enjoy subsidies funded by taxpayers, as well as federal and state tax advantages; and electric cooperatives enjoy below-market financing subsidized by the federal government, as well as state and federal tax advantages. Further, unlike investor-owned utilities; municipals, cooperatives, and public power are in most cases exempt from state regulations. The cost of capital, tax obligations, and state regulatory compliance are a significant portion of the costs incurred by private industry. If public power, municipal systems, and electric cooperatives are allowed to compete with private industry; they must relinquish the advantages described above.

The chart set forth below, prepared by South Carolina Electric & Gas (SCE&G - an investor-owned utility) comparing their tax obligation to that of the South Carolina Public Service Authority (a state-owned public power utility also known as "Santee Cooper"), graphically demonstrates the tax advantages enjoyed by public power.

	Santee Cooper	SCE&G
Electric Sales	16.9 billion kwh	17.6 billion kwh
Peak Demand	3,102 MWs	3,683 MWs
Generating Capacity	3,340 MWs	4,282 MWs
Revenues	$640.1 million	$1,006 million
Customers	104,000	484,000
1995 Federal Income Taxes	None	$97 million
1995 State Income Taxes & Assessments	$6.4 million	$14.6 million
Property Taxes	$1.9 million	$60 million
State Generation Tax	None	$6.2 million
State Licenses and Fees	None	$5.4 million
Total Taxes	$8.3 million	$183.2 million

Because public power entities and federal power marketing agencies have been accorded favorable treatment from federal, state, and local government authorities with regard to financing costs and tax liabilities, their cost of producing electricity is lower than that of investor-owned utilities and they therefore have an unfair competitive advantage. The tax laws and regulations must be applied equally to public power and investor-owned utilities to help create a level and fair playing field and to avoid hidden subsidies imposed upon taxpayers.

Additionally, there are other financial advantages afforded public power which must be considered. For example, the Rural Utilities Services' debt write-downs of hundreds of millions of dollars of below-market cooperative loans creates yet another unfair financial competitive advantage at the expense of all taxpayers. Fair and proper resolution of these financial issues is a critical prerequisite to address supplier inequities and to level the playing field.

Public power entities, federal power marketing agencies, and electric cooperatives should be subject to the same regulation of transmission service as those investor-owned utilities with whom they will compete. Specifically, they should be required to file open access transmission tariffs, maintain Open Access Same-Time Information Systems (OASIS), and abide by the FERC-mandated Standards of Conduct governing separation of marketing and transmission functions, just as investor-owned utilities are required to do in accordance with FERC's rules and regulations. FERC states in its Order 888-A, regarding open access transmission service:

> *"the Commission explained that its authority under sections 205 and 206 of the FPA permits it to require only [investor-owned] utilities to file open access tariffs...."*

Not only are non-investor-owned utilities not required to file such tariffs initially with FERC, but they need not meet FERC's reciprocity requirement that an entity taking transmission service under another utility's open access tariff must provide reciprocal service "if tax exempt status would be jeopardized." This special treatment of non-investor-owned utilities constitutes a Congressionally-granted competitive advantage that cannot be maintained if Congress wishes to facilitate a truly competitive environment.

7. If Congress enacts comprehensive restructuring legislation, should changes be made to federal, state or local tax codes, and if so why? Please be specific.

FEDERAL ISSUES

Tax Normalization Requirements[1]:
Under current law, tax normalization rules require that tax benefits associated with accelerated depreciation and investment tax credits (ITC) be reflected in a utility's rates over the period in which the customers bear the cost of the property that gave rise to the benefit. The Internal Revenue Code (IRC) requires that a utility lose the accelerated benefits of depreciation and ITC if normalization is not followed for public utility property.

As competition approaches, the functions of the electric utility industry might well become segmented. If the industry is segmented, parts of the industry (i.e. generation) will fall outside of the normal cost-of-service regulation and would begin to be market driven. Accelerated tax deductions and ITC related to this property would be treated differently in this environment and would thus be in violation of the normalization laws. The normalization laws will need to be rewritten in order to address this situation.

Nuclear Decommissioning Costs[1]:
Decommissioning costs of the nuclear power plants in the country are required to be funded by the customers receiving the plants' power. The costs are collected through the ratemaking process and are placed in irrevocable trusts for future decommissioning activity. The IRC allows a special deduction for accrued liabilities related to decommissioning; however, this deduction is calculated based upon cost-of service ratemaking. If cost-of-service ratemaking no longer exists, special provisions will need to be made to keep the incentive to prefund the nuclear decommissioning costs in a competitive environment.

Nontaxable Entities:
Cooperatives and municipalities are not subject to federal income tax. There are significant numbers of these entities selling electricity in the country today. To create a fair and equitable marketplace it will be necessary to "level the playing field" so that no one who is selling electricity has an unfair tax advantage.

[1] For more discussion of this matter, please see Federal, State and Local Tax Implications of Electric Utility Industry Restructuring by Deloitte & Touche dated October 1996.

STATE ISSUES:

With deregulation, there are several state tax law concepts that will need to be addressed, and there is no real clear direction on how any of these issues will be resolved. Since our Company operates in North and South Carolina, our discussion will primarily be directed to the laws and taxes in these states. As the following discussion will demonstrate, deregulation will have a significant impact on the tax revenues that a state receives and thus the states are the ones that should have the control over how it will be handled.

In order for a state to levy a tax upon a business or person, that business or person must have a minimum connection, or nexus, with the state. In the past this has not been a problem because electric utilities have operated in a restricted area doing restricted activities, but deregulation is going to open the door with uncertain results.

The states stand to lose significant tax dollars as it will be difficult to determine who is selling electricity in their state and who is liable for income, sales and use tax, and gross receipts taxes.

Income Tax:

North Carolina
North Carolina imposes income tax on companies which have a nexus in the state. If a company merely solicits sales of tangible personal property, then the company would be protected from the state's jurisdiction to impose an income tax under Public Law 86-272. Public Law 86-272 does not apply to sales of intangible property or sales of services. Therefore, the classification of electricity as tangible property, intangible property or service directly affects whether a state has the jurisdiction to impose an income tax on a company.

North Carolina computes its apportionment factor (% of federal taxable income taxed at the state level) for public utilities based upon sales only. The amount of income that is apportioned to North Carolina is the total sales in North Carolina divided by total sales.

All other corporations' apportionment factor is based upon sales, property and payroll. If a non-utility company having a nexus with North Carolina begins to sell electricity in North Carolina, it may be subject to this apportionment factor computation which could lower the amount of income that would be apportioned to the state. Additionally, if a corporation is located out of state, it is more difficult and costly to administer the taxing of these entities because they are not in proximity to the state taxing authorities.

South Carolina
South Carolina also imposes income tax on companies which have a nexus in the state.

South Carolina computes its apportionment factor using the three factor method (sales, property and payroll). If another entity entered the state to sell electricity, its apportionment factor could lower the amount of income apportioned to South Carolina. Once again, if a corporation is located out of state, it is difficult to administer the taxing of these entities because they are not under the watchful eye of the state taxing authorities.

Cooperatives are not subject to income tax in North or South Carolina. There is a significant amount of electricity sold by cooperatives in these states and, if a competitive environment is to truly exist, then some type of provision will need to be included in the law to treat cooperatives in the same manner as other entities selling electricity within the state.

Gross Receipts Tax:

North Carolina
The Gross Receipts Tax is imposed by North Carolina on public utility corporations in lieu of other franchise taxes. The rate is 3.22% with approximately half of the tax being returned to the municipalities in which the revenues were derived.

Non-utility corporations are taxed for franchise tax purposes based upon the greater of the value of their capital stock or the value of their property. If all utilities in North Carolina were taxed in this manner, it would be a tremendous revenue loss to the state. For example, if our Company was taxed as a non-utility corporation, we would pay approximately $60,000,000 less in "franchise tax" annually.

Additionally, the Gross Receipts Tax is not imposed on the sale of electricity within the state by non-utility companies. Therefore, there would be significant inequity if the statute is not rewritten to address these types of entities.

South Carolina
Public utilities pay Privilege License Taxes (local franchise fees) pursuant to their municipal electric service agreements. The fee is customarily 3% of the prior year's retail metered revenues within the corporate limits of the municipality. The fee is collected from customers and remitted to the municipalities annually. If companies enter the state and are not subject to these agreements, then there again will be significant price differentials between what these companies are able to charge for electricity and what the local utilities must charge.

The State of South Carolina also imposes a Public Utility Tax (also called a License Fee) on public utilities. The tax is assessed as follows: (1) .1% of the fair market value of property owned and used within the state in the conduct of business, plus (2) .3% of the gross receipts derived from services rendered from regulated business within the state during the previous calendar year. Again if a company is not defined as a public utility, it would not be subject to this tax creating yet another inequity.

Property Tax:

North Carolina
North Carolina imposes a Property Tax on the owners of real and personal property. Utility company property is appraised annually as an integrated system by the state taxing authority. Assessments are based primarily on the cost and income generating capacity of the property. The average tax rate, based on original undepreciated cost, is approximately .4%.

The business property of other taxpayers is appraised by county taxing authorities. Real property is generally appraised every 8 years. Assessments are based on sales of comparable properties. Personal property is appraised annually by applying an indexed percentage to the original cost of the property.

Cooperatives are generally taxed similar to investor-owned utilities; however, municipalities are exempt from paying state property taxes, thus creating another inequity.

With deregulation, many public utilities will be forced to abandon or write-down some of their property. The write-down will significantly reduce the property taxes that the states and local counties will receive thus sacrificing many important state-funded items such as schools and roads. Provisions will need to be made by the states to find other revenue resources or to gradually permit deregulation in their state in order to allow for the decrease in revenue. Dramatic changes without provisions for this loss in revenue could be devastating.

South Carolina
South Carolina imposes a Property Tax on the owners of real and personal property. Utility property is appraised annually as an integrated system by the state taxing authority. Assessments are based primarily on the cost and income producing capacity of the property. The average tax rate, based on original undepreciated cost, is approximately 1.2%.

The business property of other taxpayers is also appraised by state taxing authorities. The state may use various valuation methodologies, depending upon the type of property being appraised.

Cooperatives are generally taxed similar to investor-owned utilities; however, municipalities are exempt from paying state property taxes, thus creating another inequity.

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Sales and Use Tax on Purchases:

North Carolina
North Carolina imposes Sales and Use Tax on tangible personal property that will be used within the state. The general rate is 6%; however, there are a few items taxed at a lower rate such as pollution control equipment, production equipment, and software.

All corporations including cooperatives are subject to this tax; however, it is difficult to monitor the collection of the tax from out-of-state corporations that may be using tangible personal property within the state.

South Carolina
South Carolina imposes Sales and Use Tax on tangible personal property that will be used within the state. The general rate is 5%; however, there are a few items such as pollution control equipment, production equipment, and software that are exempt from sales and use tax.

All corporations including cooperatives are subject to this tax; however, it is difficult to monitor the collection of the tax from out-of-state corporations that may be using tangible personal property within the state.

Sales Tax on Electric Sales:

North Carolina
North Carolina imposes a 3% Sales Tax on most sales of electricity by utilities. CP&L collects the tax from the customers and remits it to the state. North Carolina law does not specifically address sales of electricity by non-utility companies.

All entities must collect Sales Tax and remit it to the state; however, it would be difficult to monitor this collection process if there was an out-of-state supplier of electricity.

South Carolina
South Carolina imposes a 5% Sales Tax on the sale of electricity to commercial customers within the state. CP&L collects the tax from the customers and remits it to the state.

All entities must collect Sales Tax and remit it to the state; however, it would be difficult to administer this tax on an out-of-state provider.

8. What, if any, concerns do you have about the reliability of the electric system? If the industry moved to retail competition, will adequate reserves be available? Is the transmission system capable of handling full retail competition?

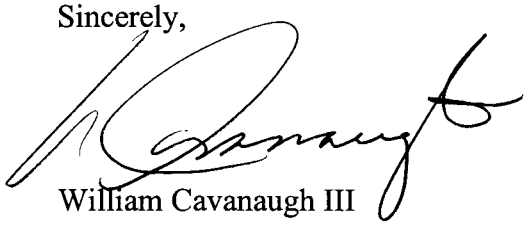
The United States has one of the world's most reliable interconnected electric systems with service delivered, on average, at lower prices than any other industrialized nation. The present generation and transmission system has been developed as an interdependent system requiring a number of load balancing services to maintain system reliability. For instantaneous matching of supplies and demand, utilities generally have a central dispatch center where system power demand, power supplies, and transmission power flows are monitored and balanced. They have system operators with intimate knowledge of all the company's generating stations including their maintenance schedules and system response characteristics. This type of tightly coordinated planning, monitoring, and control has helped ensure the reliability and quality of power in the United States.

A key reliability concern in moving to a competitive market focuses on changing from a long-term planning scenario to a short-term, market-driven plan. Historically, electric utilities and regulators forecasted growth 10-20 years out and built plants to meet these needs. They also built sufficient capacity to allow some reserve margin and they built plants of particular types to meet specific long-term needs and to provide fuel diversity. It is unknown if adequate generation reserves will be provided under a competitive scenario. Under retail competition, the market will determine what level of reserve can be supported economically. It is highly questionable if the market will find it economic to provide reserves at a level consistent with current practice. Indeed, a decline in reserve levels is already being experienced. A basic tenet of generation planning is that reserve capacity costs money and that less reserve capacity reduces cost. In a strictly cost-driven environment then, reserves would most likely decline dramatically. This reduction in reserves will adversely impact the reliability of the electric system. We can expect to experience increasing instances of tight supply during seasonal peak demand periods. Concerns about reliability, such as those in New England and the upper mid-west for this summer, will become more commonplace.

The transmission systems were designed to support delivery of power from generators located primarily in the franchised service area. Retail competition may result in significant generation in remote locations being used to supply loads. The transmission system is not capable of handling dramatic shifts in the source of generation supply. There are real constraints that limit existing transmission systems' capability to transfer power. Transmission constraints vary in response to load, which is influenced by seasonal weather changes, generating unit outages, transmission line outages, and other factors. These constraints will restrict the capability of the transmission systems to accommodate full retail competition. Mitigating these transmission constraints will require physical modifications to existing transmission lines and the construction of new lines. Constructing significant numbers of new lines may not be possible, given the increasing public resistance to siting and construction.

Finally, CP&L commends you for your commitment to understanding the facts before making any changes to the existing electric utility system. We appreciate the opportunity to share our responses to this questionnaire and would be glad to discuss them at your convenience.

Sincerely,



William Cavanaugh III